US economy posts strong first quarter, but consumer spending slows

By Lydia DePillis, CNN Business
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New York (CNN Business) The US economy grew at a much better than expected rate in the first quarter, the Commerce Department reported Friday. The top-line number is a pleasant surprise in a quarter marked by a government shutdown, severe weather, Boeing's troubles with the 737 Max, fears of an escalating trade war and the gradual fading of fiscal stimulus from tax cuts.

But digging into the details of the report reveals that weakness remains in the American economy.

The Bureau of Economic Analysis reported that gross domestic product grew at an annual rate of 3.2%, substantially above the projected 2.1%, buoyed by stronger state and local government spending, lower imports and business inventories.

The rate is a first estimate, and it may be revised as more data comes in over the next few weeks. It would have been even stronger, the BEA concluded, without the government shutdown — which subtracted 0.3 percentage points from growth in the first quarter rate. Federal spending was flat, since a rise in military spending was offset by a decline in non-defense spending.

The contribution from state and local government spending came largely as a result of highway and road construction, which localities have taken on while waiting for an infrastructure package from the federal government.

Underlying components in the report, however, suggest a broadly anticipated slowdown is still underway.

Growth was driven in part by higher inventories, especially in the manufacturing industry, which can indicate that businesses are stockpiling goods rather than selling them. Higher inventories can often foreshadow slower growth in the next quarter. Domestic private sales, which subtract out imports and exports as well as government spending, decelerated to half the rate of the previous quarter — the smallest gain in three years.

Imports collapsed, in part because businesses had rushed to bring in goods from overseas in advance of the Trump administration's tariffs last year. "With stock rooms and backlots now filling up, businesses saw no reason to buy more," wrote **Bernard Baumohl, chief global economist with the Economic Outlook Group.** "Worse, many companies now fear it will take far longer to unload all this inventory, given the apparent underlying weakness in consumer and business demand.

Meanwhile, consumer spending slowed, in part due to weak sales of goods, in particular light trucks. Business investment also slowed from the previous quarter, with agricultural machinery and office furniture posting the largest declines. The biggest boost for business investment came from intellectual property products. Exports are expected to slow, facing headwinds from a strengthening dollar.

"Taking out the oversized boosts from net trade, inventories and highways investment, which will all be reversed in the coming quarters, growth was only around 1%," wrote Paul Ashworth, chief US economist with the research firm Capital Economics. "Under those circumstances, we continue to expect that overall growth will slow this year, forcing the Fed to begin cutting interest rates before year-end."

Forecasters are already tamping down their expectations. Morgan Stanley's economics team revised their second quarter estimate to 1.1%, for example, citing the buildup in inventories. The Conference Board is slightly more optimistic, projecting 2.5% growth next quarter, but they also forecast a slowdown to 2.3% for the second half of the year.

One looming question: Will these surprising numbers change the Federal Reserve's stated plans to hold off on interest rate hikes for the remainder of the year? Not if they look at the underlying numbers, writes Joseph Brusuelas, chief economist with the accounting firm RSM US. Inflation is well below the Fed's 2% target. Core personal consumption expenditures — a key metric that strips out volatile food and energy prices — rose only 1.3% year-over-year in the first quarter.

"The Federal Reserve will look right past the 3.2% quarterly growth estimate and focus on the composition of growth, which points to a slowing trend amid softening inflation," Brusuelas wrote. "This data reinforces the prudent pause the Fed is engaged in, and forward-looking investors and chief financial officers should expect no rate hike or rate cut until 2021."

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